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C O N F I D E N T I A L SECTION 01 OF 04 BISHKEK 000593

SIPDIS

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TAGS: [ECON](#) [PGOV](#) [SOVI](#) [KG](#)

SUBJECT: THE PERFECT STORM: ECONOMIC AND ENERGY CRISIS IN
KYRGYZSTAN

REF: A. BISHKEK 328

[1](#)B. BISHKEK 428

[1](#)C. BISHKEK 501

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Classified By: Amb. Marie L. Yovanovitch, Reason 1.4 (b) and (d).

[1](#)1. (C) Summary: Economic woes -- including food price spikes, currency appreciation, low water levels, decreased electricity output, and high natural gas import costs -- have pushed the Kyrgyz government to take increasingly desperate measures. With the specter of government coffers emptying later this year, Kyrgyz authorities have mandated 20% across-the-board budget cuts and have acted to take control of all Central Bank "profits." The government has instituted some electricity rationing due to low water levels at Kyrgyz hydroelectric facilities, and it has formed a food security working group.

[1](#)2. (C) Summary continued: Even these measures, however, do not ensure that the Kyrgyz will avoid a dark, cold and hungry winter. Because of the potentially catastrophic impact on the majority of Kyrgyz citizens who survive on minimal incomes, the government is also seeking short-term support from donor organizations and countries. In response to these extraordinary difficulties, the Embassy is reorienting some of its assistance programs and has crafted a 1210 proposal for use of U.S. Department of Defense funding to counter risks of instability and security threats in southern regions of the Kyrgyz Republic close to Afghanistan. The proposal, which targets irrigation, seed supplies and agricultural machinery, aims to stabilize economic conditions among rural populations and thereby make recruitment by Islamic extremists, criminal gangs and drug trafficking rings more difficult. End summary.

Economic Troubles

[1](#)3. (C) Despite increased revenues, impressive 8% gross

domestic product (GDP) growth and continued remittances from Kyrgyz working abroad, the Kyrgyz economy is increasingly burdened by excessive government spending, a widening trade gap, and accelerating inflation. The 2008 state budget projected spending of \$1.2 billion, with a \$100 million fiscal deficit (Ref A). However, faster-than-expected spending and some one-off expenditures led the International Monetary Fund (IMF) to project that the government would run out of money in September 2008. Recognizing the dangers associated with growing fiscal problems, the government mandated a 20% spending cut across all ministries. Government officials hope that the 20% cut, which several ministries are protesting, could yield a savings of \$38.4 million.

14. (SBU) Meanwhile, inflation, stimulated by food and energy price growth, may reach 30% this year. This inflation rate contrasts sharply with single digit inflation rates of recent years. These difficulties are magnified by a rapidly expanding trade deficit. The 2004 Kyrgyz trade deficit of \$186 million has since mushroomed to a \$1.96 billion deficit from total trade turnover of \$4.27 billion in 2007.

15. (C) Remittance inflows of an estimated \$1 billion annually have increased foreign currency (dollar) holdings and generated a real estate bubble. The National Bank of the Kyrgyz Republic (the NBKR, the central bank) has intervened repeatedly during the past two years to prevent appreciation of the Kyrgyz som against the dollar. These interventions have pumped more Kyrgyz soms into the economy, stoking inflation but also preventing an even bigger tide of dollar-denominated imports into the economy. In an environment of growing government fiscal difficulties, the

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NBKR's stockpile of over \$1 billion in reserves could become a tempting target for the central government. President Bakiyev's chief economic advisor informed the Ambassador June 5 that the NBKR is now required to transfer all "profits" from its activities to central government coffers.

Food Security

16. (U) Although the Kyrgyz Republic negotiated a reprieve from Kazakhstan's ban on wheat exports (35-40% of grain is imported), Kyrgyz officials have established a food security working group and appealed to outside donors for commodity-related assistance. Nearly 60% of the basic Kyrgyz food basket consists of wheat and flour products. A late winter frost heavily damaged many fruit and vegetable crops throughout the country, and a locust plague is reducing productivity in southern regions of the Kyrgyz Republic. Embassy has heard that shepherds, who are unable to sustain their herds due to reduced grazing pastures and less abundant hay and other feedstock growth, have been selling their livestock in increasing numbers. (Note: See reftel B for more food security details. End note.)

17. (SBU) Despite the reported expansion of land under cultivation in the mostly mountainous countryside, decreasing yields from tired seed stocks and inefficient farming techniques have not generated sufficient domestic production to curtail imports of foodstuffs. Much of last winter's snowfall evaporated, rather than melted, which has reduced water available for irrigation and stunted crop production. According to the IMF, wheat imports may total \$176 million in 2008, compared to just \$70 million in 2007. This projected additional expense would likely expand the government's financial woes, and increase the trade deficit.

Gas and Electricity

18. (C) Eyeing last winter's electricity difficulties in Tajikistan, experienced industry observers are concerned that

the seriously degraded Kyrgyz electricity network, which has lacked significant investment since the Soviet era, could face a significant collapse this winter. Underinvestment in infrastructure, coupled with 30-year lows in the Toktogul reservoir (which feeds the main hydroelectric stations), has forced the Kyrgyz government to ration electricity. In some areas, power outages last for days and prevent water from being pumped to residents. Electricity tariffs are increasing, but are not slated to reach cost recovery levels for several years. To ease the modestly increased tariff burden, President Bakiyev has announced the formation of a state-financed fund to aid pensioners in paying their electricity bills.

¶9. (C) Bishkek electricity supplies are augmented by the Bishkek thermal station, which due to lack of maintenance operates at less than 50% of original capacity. With the deteriorating electricity situation and occasional blackouts in Bishkek, Kyrgyz officials are reportedly expediting measures to open the Bishkek thermal station and all four power distribution companies to foreign ownership and/or management. However, contacts report that the tender process will not be full and open competition, and it is highly unlikely that the expected cash infusion for infrastructure repair will be able to prevent serious system disruption this winter. We understand that Kyrgyz officials have rebuffed \$3 million in World Bank technical assistance for the tenders. (Comment: Proposed transparency in electricity sector helped torpedo the Highly Indebted Poor Countries debt forgiveness initiative, and may be a factor in continued obfuscation of electricity sector data. Unrecorded electricity sales are

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rumored to still be a lucrative activity for connected officials. End comment.)

¶10. (C) As the Kyrgyz Republic lacks significant natural gas and oil deposits, the country is highly dependent on winter imports of Uzbek natural gas. Natural gas prices, which rose to \$145 per thousand cubic meters earlier this year, take a huge financial toll on the central government. Upcoming natural gas negotiations may be complicated by debate over water releases from Kyrgyz reservoirs to downstream Uzbek consumers. In addition, we have heard that Uzbekistan and Kazakhstan want to cut transmission of Kyrgyz electricity, which crosses Uzbek and Kazakh territory on its way from southern power generation stations to northern consumption centers, such as Bishkek. (Note: A threatened cut-off may solely be a negotiating tactic, but, if realized, could exacerbate electricity shortages in southern Kazakhstan. See refTel C for more information about electricity and water issues. End note.)

External Support

¶11. (SBU) Sensing a difficult period ahead, the Kyrgyz government has solicited assistance from international donors. The World Bank developed a new \$10 million grant for agricultural and health care assistance. To counter a growing balance of payments imbalance caused by rising food and energy prices, the IMF has authorized an additional \$14.4 million to aid the Kyrgyz government. In a late May meeting with several members of the international donor community, President Bakiyev's chief economic advisor confirmed dire Kyrgyz economic data and emphasized the need for coordinated donor assistance.

Embassy Responses

¶12. (SBU) Largely through our USAID mission, the Embassy has begun reorienting assistance to address the difficulties described above. Under our new energy advisory program, we are hoping to add crisis planning tools. We are tailoring our existing water user association programming to be more

responsive to water shortage issues. We are considering a waiver request which would allow us to be more active in helping wheat production. Existing tax code reform and revenue sustainability projects are focusing on fiscal concerns. In addition, recent deliveries of dried soup have been well received, and we have received funding for additional deliveries. The Embassy is also working with the U.S. Treasury to reconstitute a one-year advisor program to help the Kyrgyz manage macroeconomic instability.

1210 Proposal

¶13. (SBU) In addition to our efforts with existing programming and given the gravity of the economic, food security and energy challenges, the Embassy has crafted a 1210 proposal for U.S. Department of Defense funding to alleviate pressure on the Kyrgyz Republic, especially in southern regions where the risks of instability are greatest.

The proposal, which was designed to obtain an immediate impact, aims to decrease these risks and prevent increased security threats spurred by extreme rises in prices of food, agricultural inputs and other key commodities, coupled with reduced water and energy through an integrated approach to address short-term food security concerns and build capacity for longer term increases in agricultural productivity.

¶14. (SBU) The \$12 million proposal has three components: 1) improving water irrigation systems; 2) covering the gap in

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available seeds; and 3) developing a sustainable agricultural machinery leasing program. Eliminating the sources of poverty and dissatisfaction, particularly among populations in southern rural portions of the Kyrgyz Republic close to Afghanistan, would help stem recruitment by Islamic extremists, criminal gangs and drug trafficking rings and enhance U.S. security.

Comment

¶15. (C) The Kyrgyz Republic is facing more difficult economic challenges, which are exacerbated by global food price increases and regional water and energy tensions. Too many Kyrgyz officials have been reluctant to share bad news with the Kyrgyz leadership for too long. Kyrgyz authorities are taking some short-term steps to combat these difficulties, but long-term solutions are not on the agenda yet. Amidst complementary support from other donors, the United States can help address Kyrgyz needs in the context of enhancing the regional security environment. The Embassy 1210 proposal, which has been transmitted separately to Washington, contains effective mechanisms to alleviate water, food and economic difficulties in the Kyrgyz Republic which would minimize the expansion of security instability into economically-challenged regions of the country.
YOVANOVITCH